



Congressional Budget Office

# **Economic Effects of Policies Contributing to Fiscal Tightening in 2013**

November 2012

Report Documentation Page				Form Approved OMB No. 0704-0188	
Public reporting burden for the collection of information is estimated to average 1 hour per response, including the time for reviewing instructions, searching existing data sources, gathering and maintaining the data needed, and completing and reviewing the collection of information. Send comments regarding this burden estimate or any other aspect of this collection of information, including suggestions for reducing this burden, to Washington Headquarters Services, Directorate for Information Operations and Reports, 1215 Jefferson Davis Highway, Suite 1204, Arlington VA 22202-4302. Respondents should be aware that notwithstanding any other provision of law, no person shall be subject to a penalty for failing to comply with a collection of information if it does not display a currently valid OMB control number.					
1. REPORT DATE <b>NOV 2012</b>		2. REPORT TYPE		3. DATES COVERED <b>00-00-2012 to 00-00-2012</b>	
4. TITLE AND SUBTITLE <b>Economic Effects of Policies Contributing to Fiscal Tightening in 2013</b>				5a. CONTRACT NUMBER	
				5b. GRANT NUMBER	
				5c. PROGRAM ELEMENT NUMBER	
6. AUTHOR(S)				5d. PROJECT NUMBER	
				5e. TASK NUMBER	
				5f. WORK UNIT NUMBER	
7. PERFORMING ORGANIZATION NAME(S) AND ADDRESS(ES) <b>Congressional Budget Office,Ford House Office Building, 4th Floor ,Second and D Streets, SW ,Washington,DC,20515-6925</b>				8. PERFORMING ORGANIZATION REPORT NUMBER	
9. SPONSORING/MONITORING AGENCY NAME(S) AND ADDRESS(ES)				10. SPONSOR/MONITOR'S ACRONYM(S)	
				11. SPONSOR/MONITOR'S REPORT NUMBER(S)	
12. DISTRIBUTION/AVAILABILITY STATEMENT <b>Approved for public release; distribution unlimited</b>					
13. SUPPLEMENTARY NOTES					
14. ABSTRACT					
15. SUBJECT TERMS					
16. SECURITY CLASSIFICATION OF:			17. LIMITATION OF ABSTRACT  <b>Same as Report (SAR)</b>	18. NUMBER OF PAGES  <b>16</b>	19a. NAME OF RESPONSIBLE PERSON
a. REPORT <b>unclassified</b>	b. ABSTRACT <b>unclassified</b>	c. THIS PAGE <b>unclassified</b>			



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# Economic Effects of Policies Contributing to Fiscal Tightening in 2013

**S**ubstantial changes to tax and spending policies are scheduled to take effect in January 2013, significantly reducing the federal budget deficit. According to the Congressional Budget Office's (CBO's) projections, if all of that fiscal tightening occurs, real (inflation-adjusted) gross domestic product (GDP) will drop by 0.5 percent in 2013 (as measured by the change from the fourth quarter of 2012 to the fourth quarter of 2013)—reflecting a decline in the first half of the year and renewed growth at a modest pace later in the year.<sup>1</sup> That contraction of the economy will cause employment to decline and the unemployment rate to rise to 9.1 percent in the fourth quarter of 2013. After next year, by the agency's estimates, economic growth will pick up, and the labor market will strengthen, returning output to its potential level (reflecting a high rate of use of labor and capital) and shrinking the unemployment rate to 5.5 percent by 2018.

Output would be greater and unemployment lower in the next few years if some or all of the fiscal tightening scheduled under current law—sometimes called the fiscal cliff—was removed. However, CBO expects that even if all of the fiscal tightening was eliminated, the economy would remain below its potential and the unemployment rate would remain higher than usual for some time. Moreover, if the fiscal tightening was removed and the policies that are currently in effect were kept in place indefinitely, a continued surge in federal debt during the rest of this decade and beyond would raise the risk of a fiscal crisis (in which the government would lose the

ability to borrow money at affordable interest rates) and would eventually reduce the nation's output and income below what would occur if the fiscal tightening was allowed to take place as currently set by law.

In August, CBO presented estimates of the budgetary and economic outcomes that would occur under current law and under an “alternative fiscal scenario” that represents a continuation of many long-standing policies and thus a significant reduction in the amount of fiscal tightening next year. To provide additional information about the sources of that tightening and its effects, this report presents estimates of the budgetary and economic impact of the main changes to current law that would occur under that alternative scenario, as well as estimates of the impact of eliminating various other components of fiscal tightening scheduled for 2013.

In order to focus on the short-term impact of policy decisions, the analysis in this report is based on the assumption that the fiscal tightening would be removed and current policies maintained for two years and that the tightening provided by current law would occur thereafter. (In contrast, CBO's August analysis of the alternative fiscal scenario was based on the assumption that those current policies would be maintained indefinitely.)

On the basis of its analysis, CBO concludes the following:

- Eliminating the automatic enforcement procedures established by the Budget Control Act of 2011 that are scheduled to reduce both discretionary and mandatory spending starting in January and maintaining Medicare's payment rates for physicians' services at the

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1. The figures in this paragraph are unchanged from those in CBO's previous analysis of this issue. See Congressional Budget Office, *An Update to the Budget and Economic Outlook: Fiscal Years 2012 to 2022* (August 2012).

current level would boost real GDP by *about three-quarters of a percent* by the end of 2013 (see Figure 1).<sup>2</sup>

- Extending all expiring tax provisions other than the cut in the payroll tax that has been in effect since January 2011—that is, extending the tax reductions originally enacted in 2001, 2003, and 2009 and extending all other expiring provisions, including those that expired at the end of 2011, except for the payroll tax cut—and indexing the alternative minimum tax (AMT) for inflation beginning in 2012 would boost real GDP by *a little less than 1½ percent* by the end of 2013.
- Making all of the changes described in the two preceding bullets—which captures all of the policies included in the first two years of CBO’s alternative fiscal scenario—would boost real GDP by *about 2¼ percent* by the end of 2013 (as CBO estimated in August).<sup>3</sup> Thus, of the total difference in the projected growth of GDP next year under current law and under the alternative fiscal scenario, about two-thirds owes to changes in tax policies and about one-third owes to changes in spending policies.
- The estimated economic effect next year of those changes in spending is about half the estimated effect of extending the expiring tax provisions, even though the budgetary impact of the changes in spending is less than one-quarter of the impact of the changes in taxes. The larger “bang for the buck” next year of the spending policies under the alternative fiscal scenario occurs because, CBO expects, a significant part of the decrease in taxes (relative to those under current law) would be saved rather than spent.
- Extending all expiring tax provisions other than the cut in the payroll tax and indexing the AMT for inflation—except for allowing the expiration of lower tax rates on income above \$250,000 for couples and \$200,000 for single taxpayers—would boost real GDP by *about 1¼ percent* by the end of 2013. That effect is

nearly as large as the effect of making all of those changes in law and extending the lower tax rates on higher incomes as well (which CBO estimates to be a little less than 1½ percent, as noted above), primarily because the budgetary impact would be nearly as large (and secondarily because the extension of lower tax rates on higher incomes would have a relatively small effect on output per dollar of budgetary cost).

- Extending both the current 2 percentage-point cut in the payroll tax and emergency unemployment benefits—extensions that are not assumed in the alternative fiscal scenario—would boost real GDP by *about three-quarters of a percent* by the end of 2013. Making those changes along with making all of the changes in CBO’s alternative fiscal scenario would boost real GDP by *about 3 percent* by the end of 2013.

## CBO’s Analytical Approach

For each potential change in law discussed in this report, CBO used evidence from empirical studies and econometric models to estimate the impact on:

- Output next year—specifically, the effect on real GDP in the fourth quarter of 2013 and on average nominal GDP in 2013 per dollar of total budgetary cost (measured in terms of additional government spending or reduction in taxes)—and
- Employment next year—specifically, the effect on years of full-time-equivalent (FTE) employment in the fourth quarter of 2013 and on average FTE-years in 2013 per million dollars of total budgetary cost in that year.

Although the analysis here focuses on those two measures, other criteria are also important for evaluating fiscal policies. Those other criteria include the economic effects in later years, consistency with long-term fiscal objectives, the distributional consequences (that is, who bears the costs and receives the benefits), and the value to society of any added goods and services that would be produced in the short term.<sup>4</sup>

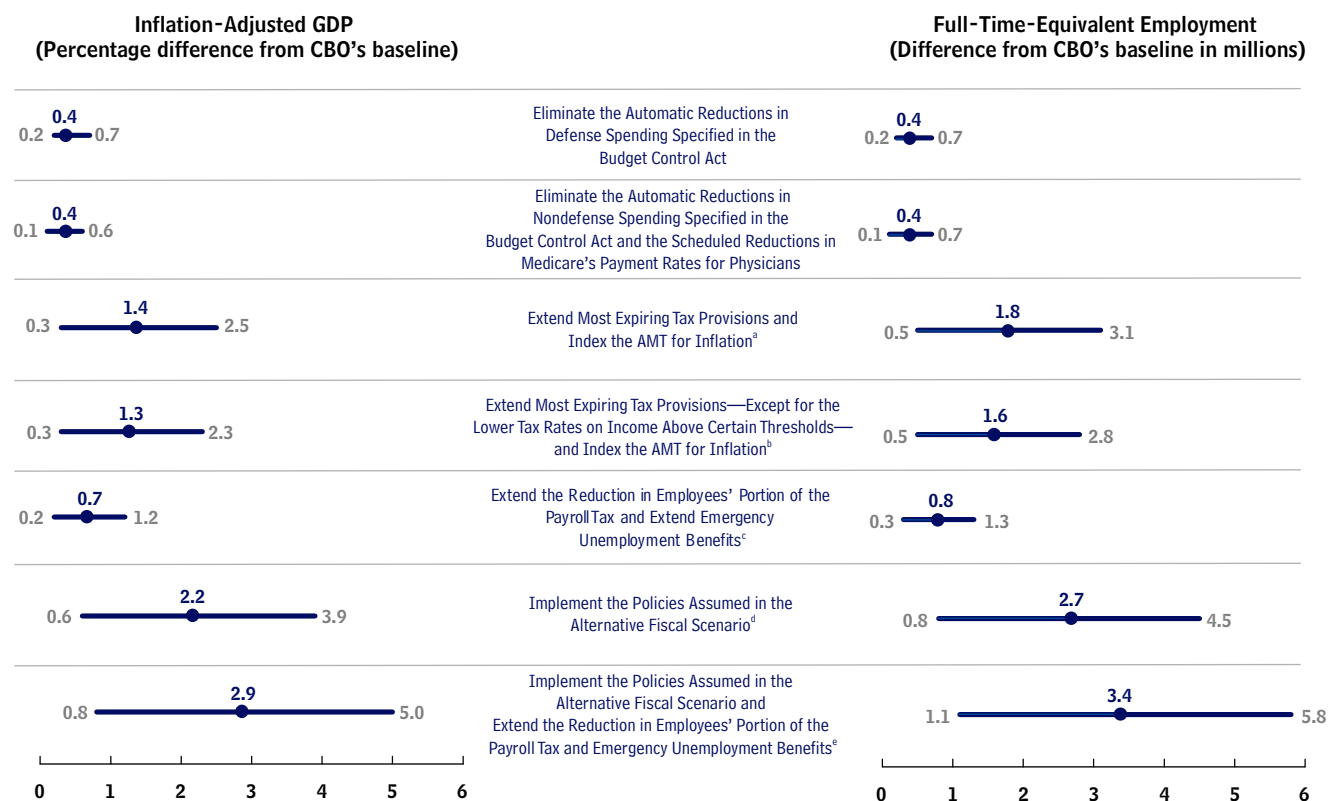
2. The economic measures presented in this report apply to calendar years. The budget figures are for fiscal years, which run from October 1 through September 30.

3. For a detailed explanation of the policies underlying the alternative fiscal scenario, see Congressional Budget Office, *An Update to the Budget and Economic Outlook: Fiscal Years 2012 to 2022* (August 2012).

4. For additional discussion of those criteria, see the statement of Douglas W. Elmendorf, Director, Congressional Budget Office, before the Joint Select Committee on Deficit Reduction, *Confronting the Nation’s Fiscal Policy Challenges* (September 13, 2011).

**Figure 1.**

## Estimated Economic Effects in the Fourth Quarter of 2013 of Eliminating Various Components of Fiscal Tightening Scheduled for Fiscal Years 2013 and 2014



Source: Congressional Budget Office.

Notes: The estimated budgetary effects presented do not include debt service.

GDP = gross domestic product; AMT = alternative minimum tax.

- This component incorporates extensions of title I of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (which extended for 2011 and 2012 income tax provisions enacted in 2001, 2003, and 2009); of title III of that act (which modified estate and gift taxation for 2010 through 2012); of the higher exemption amount for the AMT (which was previously increased through the end of December 2011), along with an indexing of higher exemption amount and AMT tax brackets for inflation after 2011; of the treatment of nonrefundable personal credits (which also was continued through the end of 2011); and of about 80 other tax provisions (many of which expired at the end of December 2011). Nearly all of those 80 provisions have been extended previously; some, such as the research and experimentation tax credit, have been extended more than once.
- This component incorporates extensions of title I of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (which extended for 2011 and 2012 income tax provisions enacted in 2001, 2003, and 2009) except for the reductions to the top two tax rates on ordinary income and to the tax rates on capital gains and dividends for taxpayers filing jointly with income above \$250,000 and for single filers with income above \$200,000 (with both thresholds indexed for inflation since 2009); of the elimination of limits on itemized deductions and personal exemptions except for those high-income taxpayers; of title III of that act (which modified estate and gift taxation for 2010 through 2012); and of about 80 other tax provisions (many of which expired at the end of December 2011). It also incorporates indexing the AMT for inflation.
- The budgetary cost is for a two-year extension of the policies.
- Implements the first two years of the alternative fiscal scenario, combining the first three components listed in the figure.
- Combines the first three components and the fifth component listed in the figure.

The approach adopted to estimate the short-term economic impact of alternative policies is similar to the method that CBO has used to assess the impact of the American Recovery and Reinvestment Act and the impact of various potential policies designed to increase output and employment.<sup>5</sup> The estimated effects on output of a given policy include both its direct and indirect effects. Direct effects consist of immediate effects on economic activity. For example, government purchases of goods and services directly elicit economic activity and thereby have a direct dollar-for-dollar impact on output. Indirect effects may enhance or offset the direct effects. For example, if the economy has idle resources, as it does now, government funding for projects can lead to the hiring of otherwise unemployed workers. The additional spending by those workers, who would have more income, would constitute a positive indirect effect. In contrast, a substantial increase in government spending financed by borrowing tends to drive up interest rates, which discourages spending on investment and on durable goods by raising the cost of borrowed funds. Those indirect “crowding-out” effects would offset some of the direct effects. In its analysis, CBO chose, on a judgmental basis, low and high estimates of the effects on output for a given policy to encompass most economists’ views about the effects of that type of policy.

The monetary policy of the Federal Reserve has an important influence on the economic effects of changes in taxes and government spending. In its August 2012 *An Update to the Budget and Economic Outlook*, CBO anticipated that the economic slowdown brought about by fiscal tightening under current law, coupled with a lack of inflationary pressure, would prompt the Federal Reserve to introduce new policies to hold down the rate on 10-year Treasury notes. Changes in the laws governing federal taxes and spending that would offset the fiscal tightening scheduled under current law and ameliorate the projected economic slowdown could lead the Federal Reserve to scale back or eliminate those policies. In this

analysis, CBO assumed that, at least through 2013, the Federal Reserve would react in that way. That reaction would increase long-term interest rates a little relative to the rates in CBO’s baseline projections and thereby slightly attenuate the economic effects of policies that would reduce fiscal tightening.

Fiscal policies may also affect spending by individuals and businesses by altering people’s uncertainty or confidence about future economic conditions or government policies. Many firms appear to be uncertain today about future demand for their products, and that uncertainty seems to be leading them to be cautious about increasing their investment and hiring. Fiscal policy actions that boosted demand might lessen that uncertainty and increase employment.<sup>6</sup> However, some fiscal policy actions might exacerbate uncertainty about future government policies—for example, if firms’ managers wondered whether a temporary policy might later be extended or what other changes in fiscal policy might be made later. Because quantifying reactions of that sort to changes in fiscal policy would be extremely difficult, this report does not incorporate such reactions.

To assess a policy’s impact on employment, CBO used a series of steps to translate the estimated effects on output into estimated effects on FTE-years (each FTE-year being 40 hours of employment per week for one year). First, CBO estimated the impact on the output gap—the percentage difference between actual output and potential output. Next, CBO calculated the magnitude and timing of effects of changes in the output gap on productivity, hours per worker, and employment using the historical relationships between those measures. Changes in the output gap affect employment gradually over several quarters, as part of a rise in output initially shows up as higher productivity and hours per worker rather than as increased employment. CBO also took account of the effect of changes in employment on the size of the labor force, because discouraged workers and people who have chosen to pursue activities such as schooling rather than work tend to return to the labor force when unemployment declines and the economic environment improves.

To measure the impact on employment in FTE-years, CBO incorporated the estimated effects of policies on the number of hours worked in addition to their effects on

5. See Congressional Budget Office, *Estimated Impact of the American Recovery and Reinvestment Act on Employment and Economic Output from April 2012 Through June 2012* (August 2012); the statement of Douglas W. Elmendorf, Director, Congressional Budget Office, before the Senate Committee on the Budget, *Policies for Increasing Economic Growth and Employment in 2012 and 2013* (November 15, 2011); and Felix Reichling and Charles Whalen, *Assessing the Short-Term Effects on Output of Changes in Federal Fiscal Policies*, Congressional Budget Office Working Paper 2012-08 (May 2012).

6. See Nicholas Bloom, “The Impact of Uncertainty Shocks,” *Econometrica*, vol. 77, no. 3 (May 2009), pp. 623–685.



the number of people employed. Projected increases in the average number of people employed during a year do not include shifts from part-time to full-time work or overtime and are generally somewhat smaller than increases in FTE-years.

For estimates of the amounts in 2013 of additional output per dollar and employment per million dollars of total budgetary cost, the cost used in the calculations was the effect on the federal deficit in calendar year 2013. Policy options with a smaller impact per dollar require more budgetary resources to generate given amounts of extra output and employment, and those with a larger impact per dollar require less budgetary resources.<sup>7</sup>

Since its November 2011 analysis presented in *Policies for Increasing Economic Growth and Employment in 2012 and 2013*, CBO has refined some aspects of its analytic approach and its presentation of results. For example, CBO now estimates that changes in GDP affect employment more gradually than it estimated previously. That change implies that generating a given increase in employment in the first year of a policy requires a larger increase in GDP. In addition, CBO now presents the effects of different policies on nominal GDP per dollar of budgetary cost, whereas the previous analysis presented the effects on real GDP measured with 2008 prices; that change in presentation (which better matches the effect on GDP to the budgetary cost of a policy, measured in nominal dollars) has slightly increased the effects on output per dollar of budgetary cost presented in this report, while leaving the effects on employment unchanged.

Since its August 2012 analysis of the alternative fiscal scenario, CBO has made one change of note: To focus on the short-term impact of the policies that constitute that scenario and the others analyzed in this report, the current analysis is based on the assumption that the policies would be maintained through calendar year 2014 and that

the changes embodied in current law would unfold thereafter. In contrast, the August analysis was based on the assumption that the policies would be maintained indefinitely. Shortening the duration of the policies significantly reduces their cumulative budgetary effects and therefore their drag on output and income in the long run. However, that shorter duration makes little difference in the policies' projected budgetary and economic effects in the short run. In particular, because the tax cuts have been in place for so long, CBO expects that households would view an extension of current tax rates as a continuation of established tax policy and would therefore alter their spending very little. If households viewed the two-year extension as less than permanent, they might spend less and provide a smaller short-term boost to economic output. However, that effect might be offset by a positive effect from a smaller increase in long-term interest rates if participants in the financial markets felt less concerned about the prospect of higher government debt in the future.

## Short-Term Effects of Policies Contributing to Fiscal Tightening

CBO estimated the short-term impact on output and employment of five sets of policies:

- Eliminate the scheduled automatic reductions in defense spending;
- Eliminate the scheduled automatic reductions in nondefense spending and the scheduled reductions in Medicare's payment rates for physicians;
- Extend most expiring tax provisions and index the AMT for inflation;
- Extend most expiring tax provisions—except for the lower tax rates on income above certain thresholds—and index the AMT for inflation; and
- Extend both the payroll tax cut and emergency unemployment benefits.

CBO also estimated the impact of two combinations of those sets of policies:

- The alternative fiscal scenario, which encompasses the first three items listed above, and

7. One might attempt to calculate the budgetary cost per FTE-year for different policies by inverting the number of cumulative years of full-time employment per million dollars of budgetary cost (reported below). However, such calculations could be misleading for two reasons. First, for many of the options considered here, employment is affected beyond 2013—in part because effects on employment tend to lag behind those on GDP. Second, CBO's ranges of estimated effects on GDP (and thereby employment) are chosen to be centered relative to the distribution of possible outcomes, but the inverses of those ranges are not necessarily centered relative to the distribution of the inverses of those outcomes.



- The alternative fiscal scenario plus an extension of the payroll tax cut and emergency unemployment benefits (the first three items and the last one).

The effects of the policies differ both because they vary in their budgetary cost and because they spur output and employment by different amounts per dollar of budgetary cost.

### **Eliminate the Automatic Reductions in Defense Spending Specified in the Budget Control Act**

The Budget Control Act specified automatic procedures to reduce both discretionary and mandatory spending during the coming decade in the event that specified amounts of deficit reduction were not achieved through legislation originating from a Congressionally appointed committee.<sup>8</sup> Those automatic reductions will take the form of equal cuts (in dollar terms) in funding for defense and nondefense programs in fiscal years 2013 through 2021. For 2013, those reductions will be achieved by automatically canceling a portion of the budgetary resources (in an action known as sequestration) for most discretionary programs as well as for some programs and activities that are financed by mandatory spending.<sup>9</sup> From 2014 to 2021, the reductions will be achieved by lowering the caps on discretionary budget authority as specified in the Budget Control Act and through sequestration for mandatory spending. The law exempts a significant portion of mandatory spending from sequestration, however.

CBO has previously estimated how much discretionary and mandatory funding will change under the automatic enforcement mechanisms, and those estimates are used in this analysis. However, the Administration's Office of Management and Budget would implement any reductions on the basis of its own estimates.<sup>10</sup>

8. Discretionary spending is spending out of budget authority provided in appropriation acts. Mandatory spending is spending on programs that are not normally controlled by the annual appropriation process; many of them provide benefits based on formulas and eligibility criteria set in law.
9. Budgetary resources consist of all sources of authority provided to federal agencies that permit them to incur financial obligations, including new budget authority, unobligated balances, direct spending authority, and obligation limitations.

CBO estimated in August that the automatic enforcement procedures will reduce outlays for defense programs by \$24 billion in fiscal year 2013 and by \$51 billion in fiscal year 2014 (see Table 1). Because mandatory spending makes up less than 1 percent of all defense spending, almost all of that reduction in outlays in the defense category will be achieved by sequestering discretionary budget authority provided for 2013 and by lowering the caps on defense appropriations in 2014.

CBO estimates that precluding those reductions in defense outlays would increase real GDP by 0.4 percent and increase full-time-equivalent employment by about 0.4 million in the fourth quarter of 2013 (see Figure 1 on page 3). Those figures represent CBO's central estimates, which correspond to the assumption that the values that describe key parameters of economic behavior (in particular, the extent to which lower federal taxes and higher federal spending boost aggregate demand in the short term) equal the midpoints of the ranges used by CBO.<sup>11</sup> The full ranges that CBO uses for those parameters suggest that, in the fourth quarter of 2013, real GDP could be between 0.2 percent and 0.7 percent higher, and employment 0.2 million to 0.7 million higher, if the scheduled reductions in defense outlays did not occur.

CBO measures the cost-effectiveness of a fiscal policy in generating additional output and employment by the ratio of its economic effects to its budgetary cost. On that basis, CBO estimates that eliminating the automatic reductions in defense spending would boost GDP in 2013 by about \$1.20 for every dollar of budgetary cost in that year; the full range of estimates runs from \$0.50 to \$2.00 of GDP per dollar of budgetary cost (see Figure 2). That policy is estimated to boost employment by about 7 FTE-years in 2013 per million dollars of budgetary cost, but that amount could range from 3 to 11 FTE-years.

10. See *OMB Report Pursuant to the Sequestration Transparency Act of 2012* (September 14, 2012) for the Office of Management and Budget's estimates of the effects of the potential sequestration for 2013. Those estimates differ slightly from the totals that CBO published in August in *An Update to the Budget and Economic Outlook: Fiscal Years 2012 to 2022*.
11. For a discussion of CBO's approach to analyzing the short-term effects of fiscal policy, see Reichling and Whalen, *Assessing the Short-Term Effects on Output of Changes in Federal Fiscal Policies*.

**Table 1.**

## Estimated Increase in the Deficit from Eliminating Various Components of Fiscal Tightening Scheduled for Fiscal Years 2013 and 2014

(Billions of dollars)

	2013	2014
Eliminate the Automatic Reductions in Defense Spending Specified in the Budget Control Act <sup>a</sup>	24	51
Eliminate the Automatic Reductions in Nondefense Spending Specified in the Budget Control Act and the Scheduled Reductions in Medicare's Payment Rates for Physicians <sup>a</sup>	40	61
Extend Most Expiring Tax Provisions and Index the AMT for Inflation <sup>a,b</sup>	330	420
Extend Most Expiring Tax Provisions—Except for the Lower Tax Rates on Income Above Certain Thresholds—and Index the AMT for Inflation <sup>a,c</sup>	288	382
Extend the Reduction in Employees' Portion of the Payroll Tax and Extend Emergency Unemployment Benefits <sup>d</sup>	108	150
Implement the Policies Assumed in the Alternative Fiscal Scenario <sup>a,e</sup>	395	532
Implement the Policies Assumed in the Alternative Fiscal Scenario and Extend the Reduction in Employees' Portion of the Payroll Tax and Emergency Unemployment Benefits <sup>f</sup>	503	682

Source: Congressional Budget Office.

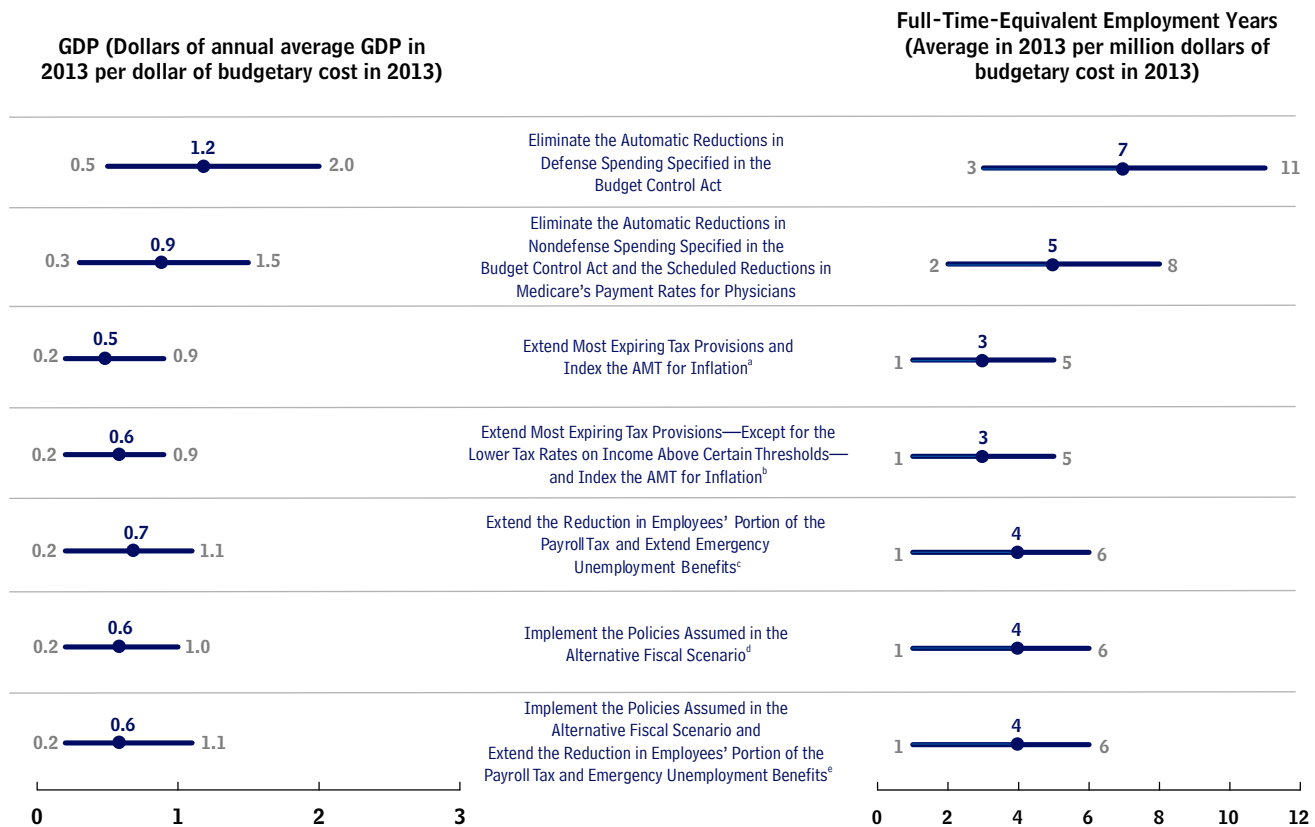
Notes: The estimated budgetary effects presented do not include debt service.

AMT = alternative minimum tax.

- The estimated effect on the budget represents the cost in fiscal years 2013 and 2014 of a 10-year extension of the policy, as shown in Congressional Budget Office, *An Update to the Budget and Economic Outlook: Fiscal Years 2012 to 2022* (August 2012).
- This component incorporates extensions of title I of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (which extended for 2011 and 2012 income tax provisions enacted in 2001, 2003, and 2009); of title III of that act (which modified estate and gift taxation for 2010 through 2012); of the higher exemption amount for the AMT (which was previously increased through the end of December 2011), along with an indexing of higher exemption amount and AMT tax brackets for inflation after 2011; of the treatment of nonrefundable personal credits (which also was continued through the end of 2011); and of about 80 other tax provisions (many of which expired at the end of December 2011). Nearly all of those 80 provisions have been extended previously; some, such as the research and experimentation tax credit, have been extended more than once.
- This component incorporates extensions of title I of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (which extended for 2011 and 2012 income tax provisions enacted in 2001, 2003, and 2009) except for the reductions to the top two tax rates on ordinary income and to the tax rates on capital gains and dividends for taxpayers filing jointly with income above \$250,000 and for single filers with income above \$200,000 (with both thresholds indexed for inflation since 2009); of the elimination of limits on itemized deductions and personal exemptions except for those high-income taxpayers; of title III of that act (which modified estate and gift taxation for 2010 through 2012); and of about 80 other tax provisions (many of which expired at the end of December 2011). It also incorporates indexing the AMT for inflation.
- The budgetary cost is for a two-year extension of the policies.
- Implements the first two years of the alternative fiscal scenario, combining the first three components listed in the table.
- Combines the first three components and the fifth component listed in the table.

**Figure 2.**

## Estimated Economic Effects in 2013 of Eliminating Various Components of Fiscal Tightening Scheduled for Fiscal Years 2013 and 2014 Relative to Budgetary Costs in 2013



Source: Congressional Budget Office.

Notes: The estimated budgetary effects presented do not include debt service.

GDP = gross domestic product; AMT = alternative minimum tax.

- This component incorporates extensions of title I of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (which extended for 2011 and 2012 income tax provisions enacted in 2001, 2003, and 2009); of title III of that act (which modified estate and gift taxation for 2010 through 2012); of the higher exemption amount for the AMT (which was previously increased through the end of December 2011), along with an indexing of higher exemption amount and AMT tax brackets for inflation after 2011; of the treatment of nonrefundable personal credits (which also was continued through the end of 2011); and of about 80 other tax provisions (many of which expired at the end of December 2011). Nearly all of those 80 provisions have been extended previously; some, such as the research and experimentation tax credit, have been extended more than once.
- This component incorporates extensions of title I of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (which extended for 2011 and 2012 income tax provisions enacted in 2001, 2003, and 2009) except for the reductions to the top two tax rates on ordinary income and to the tax rates on capital gains and dividends for taxpayers filing jointly with income above \$250,000 and for single filers with income above \$200,000 (with both thresholds indexed for inflation since 2009); of the elimination of limits on itemized deductions and personal exemptions except for those high-income taxpayers; of title III of that act (which modified estate and gift taxation for 2010 through 2012); and of about 80 other tax provisions (many of which expired at the end of December 2011). It also incorporates indexing the AMT for inflation.
- The budgetary cost is for a two-year extension of the policies.
- Implements the first two years of the alternative fiscal scenario, combining the first three components listed in the figure.
- Combines the first three components and the fifth component listed in the figure.

### **Eliminate the Automatic Reductions in Nondefense Spending Specified in the Budget Control Act and the Scheduled Reductions in Medicare's Payment Rates for Physicians**

Estimating the amount of the automatic reductions for nondefense programs is more complicated than estimating those reductions for defense programs, particularly because provisions in the Budget Control Act limit cuts in most Medicare benefits to 2 percent and exempt many mandatory programs (including Social Security and Medicaid) from sequestration altogether. Taking those limitations into account, CBO estimated in August that, in fiscal year 2013, the automatic enforcement procedures will reduce Medicare spending by about \$4 billion (including indirect effects), other mandatory spending by \$5 billion, and other nondefense spending by \$21 billion. In total, the enforcement procedures will reduce nondefense outlays by about \$30 billion in fiscal year 2013 and by \$45 billion in fiscal year 2014.

In addition, under current law, spending for Medicare will be constrained starting in January 2013 by a rate-setting system called the sustainable growth rate, which controls the fees that physicians receive for their services. If the system is allowed to operate as currently structured, physicians' fees will be reduced by 27 percent at the beginning of the year and by additional amounts in subsequent years, CBO projected in August. If, instead, lawmakers override those scheduled reductions—as they have every year since 2003—spending on Medicare would be greater than the amounts projected in CBO's baseline. For example, if payment rates stayed as they are now, outlays for Medicare (net of premiums) would be \$10 billion higher in fiscal year 2013 and \$16 billion higher in fiscal year 2014 than they are in CBO's current-law baseline.<sup>12</sup>

Together, eliminating the automatic reductions in nondefense spending and maintaining Medicare's current payment rates for physicians would increase outlays by \$40 billion in fiscal year 2013 and by \$61 billion in fiscal year 2014, according to CBO's estimates.

CBO projects that the additional spending would increase real GDP by 0.4 percent (by 0.1 percent to 0.6 percent under CBO's full range of assumptions) and increase full-time-equivalent employment by 0.4 million (with a range from 0.1 million to 0.7 million) in the fourth quarter of 2013. Dividing those economic effects by the budgetary cost of the policies yields an estimated increase in GDP of about \$0.90 in 2013 for every dollar of budgetary cost in that year (the full range of estimates runs from \$0.30 to \$1.50); the increase in employment would be about 5 FTE-years in 2013 per million dollars of budgetary cost (the full range is from 2 to 8 FTE-years).

Those economic effects per dollar are smaller than the effects of the changes in defense spending because a larger share of the affected nondefense spending represents government payments to people or state and local governments, rather than direct purchases of goods and services. Because people and state and local governments would not spend all of such payments in 2013, the increases in nondefense spending have a smaller per-dollar effect on aggregate demand.

### **Extend Most Expiring Tax Provisions and Index the AMT for Inflation**

CBO projects that federal revenues will increase by about one-third between fiscal years 2012 and 2014 as a result of several factors, including the scheduled expiration at the end of 2012 of a number of tax provisions and the expiration at the end of 2011 of certain provisions related to the AMT. As a result, under current law, revenues will reach 19.6 percent of GDP in 2014, compared with 15.8 percent in 2012, CBO estimates.

Under the rules that govern CBO's baseline, all of the provisions of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 are assumed to expire as scheduled. Those expirations will increase revenues in 2013 by raising individual income tax rates, reducing the child tax credit, eliminating the American Opportunity Tax Credit, raising estate tax rates, lowering the effective exemption amount for the AMT (which rose at the end of December 2011), and making other changes.

In addition, numerous other tax provisions—beyond the income tax, estate and gift tax, and AMT provisions—expired at the end of 2011 or are scheduled to expire at

12. On November 1, 2012, the Centers for Medicare and Medicaid Services issued a final rule specifying that Medicare's payment rates for physicians' services during calendar year 2013 will be 26.5 percent lower than current payment rates. That recent action is not reflected in CBO's estimates used for this report.

some point during the next 10 years. The staff of the Joint Committee on Taxation (JCT) and CBO estimate that the total impact of extending all expiring tax provisions (other than the cut in the payroll tax that has been in effect since the beginning of 2011) and indexing the AMT for inflation beginning in 2012 would be to reduce revenues and increase outlays for refundable tax credits by \$330 billion in fiscal year 2013 and by \$420 billion in fiscal year 2014.

CBO estimates that such a change in law would increase real GDP by 1.4 percent (by between 0.3 percent and 2.5 percent under CBO's full range of assumptions) and increase full-time-equivalent employment by 1.8 million (with a range from 0.5 million to 3.1 million) in the fourth quarter of 2013. Dividing those economic effects by the budgetary cost of the change yields an estimated increase in GDP in 2013 of about \$0.50 for every dollar of budgetary cost in that year (the full range of estimates runs from \$0.20 to \$0.90) and an estimated increase in employment of about 3 FTE-years in 2013 per million dollars of budgetary cost (the full range is from 1 to 5 FTE-years).<sup>13</sup>

The estimated economic impact of those policies per dollar of budgetary cost is smaller than that of eliminating the scheduled reductions in spending because people would save some of their extra after-tax income rather than spending it all in 2013. As a result, the short-run increase in aggregate demand and output would be smaller than it would be for increased government purchases of goods and services, which would directly add dollar for dollar to aggregate demand in 2013.

### **Extend Most Expiring Tax Provisions—Except for the Lower Tax Rates on Income Above Certain Thresholds—and Index the AMT for Inflation**

The budgetary cost of extending the expiring tax provisions would be lower if certain provisions were allowed to

expire that otherwise would apply to some high-income households.<sup>14</sup> According to JCT and CBO's estimates, if the AMT was indexed for inflation beginning in 2012 and all of the other expiring tax provisions were extended except for the specific provisions affecting high-income taxpayers (and the payroll tax cut), revenues would be lower and outlays for refundable credits would be higher by \$288 billion in fiscal year 2013 and by \$382 billion in fiscal year 2014, compared with CBO's baseline projections.

CBO estimates that such changes would increase real GDP by 1.3 percent (by 0.3 percent to 2.3 percent under CBO's full range of assumptions), and increase full-time-equivalent employment by 1.6 million (with a range from 0.5 million to 2.8 million) in the fourth quarter of 2013. Dividing those economic effects by the budgetary cost yields an estimated increase in GDP of about \$0.60 in 2013 for every dollar of budgetary cost in that year, with the full range of estimates running between \$0.20 and \$0.90, and an estimated increase in employment of about 3 FTE-years in 2013 per million dollars of budgetary cost, with a full range from 1 to 5 FTE-years.

The estimated economic effects per dollar of budgetary cost of these changes in law are slightly larger than those of extending all of the expiring tax provisions (except for the payroll tax cut) and indexing the AMT for inflation because the income affected by the higher tax rate under this policy would be that of high-income taxpayers, who, in comparison with others, probably save a larger portion and spend a smaller portion of each dollar of reduced taxes. However, the differences in the estimated effects of the two sets of policies are small (and therefore are generally not visible in the rounded numbers shown in Figure 2 on page 8), in part because the tax savings on

13. The estimated effects on GDP per dollar of budgetary cost are somewhat larger than those CBO estimated for a similar policy in November 2011. The difference arises because the previous analysis applied to a one-year extension of expiring tax provisions and reported economic effects for that year relative to the full budgetary cost (including the part of the cost that would spill over to a second year), whereas the current analysis applies to a two-year extension of expiring tax provisions and reports economic effects for the first year relative to the budgetary cost in that year alone.

14. Specifically, this alternative policy incorporates extensions of title I of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (which extended for 2011 and 2012 income tax provisions enacted in 2001, 2003, and 2009) except for the reductions to the top two tax rates on ordinary income and to the tax rates on capital gains and dividends for taxpayers filing jointly with income above \$250,000 and for single filers with income above \$200,000 (with both thresholds indexed for inflation since 2009); of the elimination of limits on itemized deductions and personal exemptions except for those high-income taxpayers; and of title III of that act (which modified estate and gift taxation for 2010 through 2012). It also incorporates indexing the AMT for inflation.

income above the specified thresholds are a small share of the total tax savings under the broader option and in part because high-income taxpayers are presumed to save only a modestly larger portion of reductions in their taxes.

### **Extend the Reduction in Employees' Portion of the Payroll Tax and Extend Emergency Unemployment Benefits**

Employees' share of the payroll tax was reduced by 2 percentage points (from 6.2 percent to 4.2 percent) for calendar years 2011 and 2012, reducing federal revenues in fiscal years 2011 through 2013. CBO estimates that the scheduled expiration of that tax cut will boost revenues as a share of GDP by 0.7 percentage points between 2012 and 2014.

Emergency unemployment compensation, which was extended in the Middle Class Tax Relief and Job Creation Act of 2012, is scheduled to expire at the end of 2012, so people will not be eligible to receive such benefits next year or beyond. As a result, outlays for unemployment compensation will be smaller in 2013 than in 2012 for any given level of unemployment.

If the cut in the payroll tax and eligibility to receive emergency unemployment benefits were extended through 2014, revenues would be lower and benefit payments higher by a combined \$108 billion in fiscal year 2013 and \$150 billion in fiscal year 2014.<sup>15</sup> Those changes in law would increase real GDP by 0.7 percent (by 0.2 percent to 1.2 percent under CBO's full range of assumptions) and increase full-time-equivalent employment by 0.8 million (with a range from 0.3 million to 1.3 million) in the fourth quarter of 2013, CBO estimates. Dividing those economic effects by the budgetary cost yields an estimated increase in GDP of about \$0.70 in 2013 for every dollar of budgetary cost in that year, with the full range of estimates running from \$0.20 and \$1.10, and an increase in employment of about 4 FTE-years in 2013 per million dollars of budgetary cost, with a full range from 1 to 6 FTE-years.

15. The great majority of that budgetary impact—\$86 billion in fiscal year 2013 and \$119 billion in fiscal year 2014—stems from the payroll tax reduction. There would also be a small budgetary effect in fiscal year 2015.

The estimated economic impact of those policies per dollar of budgetary cost is larger than that of extending other expiring tax provisions and indexing the AMT for inflation because a larger share of the additional unemployment benefits and extended payroll tax cut would be spent by the recipients in 2013. As a result, the short-run increase in aggregate demand and output would be greater.

### **Implement All of the Policies Assumed in the Alternative Fiscal Scenario**

Making all of the changes included in the first two years of CBO's alternative fiscal scenario—namely, making all of the changes to federal spending described above, extending all of the expiring tax provisions (except the payroll tax cut), and indexing the AMT for inflation—would increase spending and reduce taxes by a combined \$395 billion in fiscal year 2013 and \$532 billion in 2014 (excluding the effects on interest payments), according to JCT and CBO's estimates in August.

CBO estimates that such changes in law would boost real GDP by 2.2 percent (by between 0.6 percent and 3.9 percent under CBO's full range of assumptions) and increase full-time-equivalent employment by 2.7 million (with a range from 0.8 million to 4.5 million) in the fourth quarter of 2013. About two-thirds of those effects would owe to changes in tax policies and about one-third to changes in spending policies. The economic effects of the tax and spending changes are not proportional to their budgetary effects because, by CBO's estimates, the spending changes would boost GDP more than the tax changes would for each dollar of budgetary cost.

### **Implement All of the Policies Assumed in the Alternative Fiscal Scenario and Extend the Payroll Tax Reduction and Emergency Unemployment Benefits**

Making all of the changes included in the first two years of CBO's alternative fiscal scenario as well as extending both the reduction in the payroll tax and emergency unemployment benefits would increase the deficit by \$503 billion in 2013 and by \$682 billion in 2014. CBO estimates that such changes in law would boost real GDP by 2.9 percent (by between 0.8 percent and 5.0 percent under CBO's full range of assumptions) and increase full-time-equivalent employment by 3.4 million (with a

range from 1.1 million to 5.8 million) in the fourth quarter of 2013.<sup>16</sup>

CBO's August 2012 projection of the deficit under current law in fiscal year 2013—\$641 billion—would represent a decline in the deficit of \$448 billion from fiscal year 2012 to fiscal year 2013; that amount is less than the estimated \$503 billion budgetary cost in 2013 of the combination of the policies in the alternative fiscal scenario plus extension of the payroll tax cut and emergency unemployment benefits.<sup>17</sup> That difference occurs because CBO's baseline projection of the deficit includes effects on the budget of the macroeconomic impact of the scheduled fiscal tightening, other scheduled changes in policy not part of the combination being analyzed here, and other factors that normally affect year-to-year changes in revenues and spending.

## Longer-Term Effects of Policies Contributing to Fiscal Tightening

Although reducing the fiscal tightening scheduled to occur next year would boost output and employment in the short run, doing so without imposing a comparable amount of additional tightening in future years would reduce the nation's output and income in the longer run relative to what would occur if the scheduled tightening remained in place. If all of the policies considered in this analysis were extended for a prolonged period beyond the

two years assumed here, federal debt held by the public—which is currently more than 70 percent of GDP, its highest mark since 1950—would continue to rise much faster than GDP. Such a path for federal debt could not be sustained indefinitely, so policy changes would be required at some point.<sup>18</sup>

Over the longer term, the nation's potential to produce goods and services is the key determinant of output and income. That potential depends on the size and quality of the labor force, the stock of productive capital (such as factories, vehicles, and computers), and the efficiency with which labor and capital are used. Lasting changes in those factors can have an enduring influence on the economy's ability to produce goods and services.

Federal budget policies affect potential output mainly by affecting the amount of public saving (the combined surpluses or deficits run by the federal government and state and local governments) and the incentives for people and businesses to work, save, and invest. Different methods of achieving any given increase in public saving could have different effects on those incentives. For example, increases in marginal tax rates on labor would tend to reduce the amount of labor supplied to the economy, whereas increases in revenues of a similar magnitude from broadening the tax base would probably have a smaller negative impact or even a positive impact on the supply of labor.<sup>19</sup> Similarly, cutting government benefit payments would generally strengthen people's incentive to work and save, but the actual impact would depend on the nature of the cuts.

16. CBO's central estimate of a 2.9 percent increase in GDP in the fourth quarter of 2013 from the policies of the alternative fiscal scenario and extension of the payroll tax reduction and emergency unemployment benefits—undoing nearly all of the changes in policy that lead to fiscal tightening under current law—is notably smaller than a previous estimate of 3.9 percent for removing all of the scheduled fiscal restraint (see Congressional Budget Office, *Economic Effects of Reducing the Fiscal Restraint That Is Scheduled to Occur in 2013*, May 2012). Those estimates differ primarily because CBO now projects a smaller decline in the deficit between 2012 and 2013, in part because the deficit in 2012 turned out to be smaller than the agency projected.

17. In August, CBO projected that the decline in the deficit under current law would be \$487 billion. Because the deficit in 2012 turned out to be smaller than CBO projected, that difference is now \$448 billion.

18. See Congressional Budget Office, *The 2012 Long-Term Budget Outlook* (June 2012).

19. Broadening the tax base would have opposing effects on the supply of labor. On the one hand, reducing taxpayers' after-tax income would tend to cause them to work more to make up for the loss in income. On the other hand, some approaches for broadening the base would raise some taxpayers' marginal tax rates—by pushing them into higher tax brackets, for example—which would tend to cause them to work less. Whether the net effect was positive or negative would depend upon the details of the base-broadening policy.



CBO has not estimated the longer-term economic effects of the fiscal policies analyzed in this report, but the agency has estimated the effect on output that would occur in 2022 under the alternative fiscal scenario, which incorporates the assumption that several of the policies are maintained indefinitely. CBO estimates that in 2022, on net, the policies included in the alternative fiscal scenario would reduce real GDP by 0.4 percent and real gross national product (GNP) by 1.7 percent.<sup>20</sup> That projected effect primarily reflects two opposing forces: People's incentives to work and save would be greater with that scenario's lower tax rates, but the larger budget deficits and rapidly growing federal debt would hamper national saving and investment and thus reduce output and income.

In years beyond 2022, rising deficits under the alternative fiscal scenario would lead to larger negative effects on GDP and GNP and to larger increases in interest rates relative to the rates that would prevail under current law. Ultimately, the policies assumed in the alternative fiscal scenario would lead to unsustainable federal debt, from both an economic and a budgetary perspective.

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20. Those figures represent CBO's central estimates, which correspond to the assumption that the values that describe key parameters of economic behavior (in particular, the extent to which higher deficits crowd out private investment and the extent to which lower marginal tax rates on labor income boost the labor supply) equal the midpoints of the ranges used by CBO. The full ranges that CBO uses for those parameters suggest that in 2022 real GDP could be between 2.0 percent lower and 2.1 percent higher, and real GNP between 3.5 percent lower and 0.9 percent higher, under the policies of the alternative fiscal scenario than under current law.

GNP differs from GDP primarily by including the capital income that residents earn from investments abroad and excluding the capital income that nonresidents earn from domestic investments. GNP is a better measure for analyzing the impact of growing deficits and debt on income because projected budget deficits would be partly financed by inflows of capital from other countries that would lead to a future flow of income to those countries.

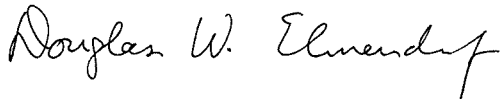
For a more detailed discussion of CBO's longer-term estimates of economic effects of fiscal policies, see Congressional Budget Office, *The 2012 Long-Term Budget Outlook* (June 2012), pp. 29–40.

## About This Document

**T**his Congressional Budget Office (CBO) report was prepared in response to a request by the Chairman of the Senate Finance Committee. In keeping with CBO's mandate to provide objective, impartial analysis, this report makes no recommendations.

Benjamin Page and Felix Reichling of CBO's Macroeconomic Analysis Division prepared the report, under the supervision of Wendy Edelberg and William Randolph. Mark Booth, Jeffrey Holland, and Christina Hawley Anthony assisted with the analysis.

John Skeen edited the report, and Maureen Costantino prepared it for publication. This report and other CBO publications are available at the agency's Web site ([www.cbo.gov](http://www.cbo.gov)).



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November 2012